(5)

No. 98-2043

In The

Supreme Court of the United States

HUNT-WESSON, INC.,

Petitioner,

v.

FRANCHISE TAX BOARD,

Respondent.

On Writ Of Certiorari To The Court Of Appeal Of California For The First Appellate District

JOINT APPENDIX

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Petition For Certiorari Filed June 22, 1999
Certiorari Granted September 28, 1999

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SUPERIOR COURT OF THE STATE OF CALIFORNIA

COUNTY OF SAN FRANCISCO

HUNT-WESSON, INC., Formerly Known as Beatrice/Hunt-Wesson, a Successor by Merger with Beatrice Company, Formerly Known as CagSub, Inc., a Successor in Interest to Beatrice Companies, Inc., Formerly Known as Beatrice Foods Company,	No 976628 **VERIFIED COMPLAINT FOR REFUND OF TAXES** Date: Time: (Filed Mar. 7, 1996)

Plaintiff,

v.

FRANCHISE TAX BOARD, an Agency of the State of California,

Defendant.

Plaintiff complains and alleges as follows:

1. Plaintiff, Hunt-Wesson, Inc., Formerly Known as Beatrice/Hunt-Wesson, a Successor by Merger with Beatrice Company, Formerly Known as CagSub, Inc., a Successor in Interest to Beatrice Companies, Inc., Formerly Known as Beatrice Foods is, and at all relevant times was, a corporation organized and existing under the laws of Delaware, with its principal place of business in Fullerton, California.

2. Defendant, Franchise Tax Board, is, and at all times mentioned herein was, an agency of the State of California empowered to assess and collect taxes under the California Revenue and Taxation Code, and to make refunds of overpayments of such taxes, with interest.

3. Jurisdiction and venue for this action is vested in this Court under Sections 19382 et seq. of the Revenue and Taxation Code and Section 401 of the Code of Civil Procedure.

4. This is an action for refund of franchise taxes paid by Plaintiff under the provisions of the California Revenue and Taxation Code for the fiscal years ended February 28, 1981 and February 28, 1982 ("the fiscal years in issue").

5. Plaintiff filed timely California franchise tax returns with Defendant for the fiscal years in issue.

6. During the fiscal years in issue, Plaintiff incurred interest expense in the amounts set forth in Exhibit A, attached to this Complaint. All such interest expense was claimed as a deduction on Plaintiff's California franchise tax returns for the fiscal years in issue.

7. During the fiscal years in issue, Plaintiff owned directly or indirectly certain non-unitary interest and dividend paying subsidiaries, each of which was incorporated under the laws of a state other than California or of a foreign country.

8. All of the interest expense claimed by Plaintiff as a deduction for the fiscal years in issue was paid on debt obligation incurred in the unitary business conducted by Plaintiff.

9. The disallowance of Plaintiff's interest expense by Defendant was due entirely to the receipt by Plaintiff of interest and dividends from its non-unitary subsidiaries.

10. None of the interest or dividends from the non-unitary subsidiaries was subject to taxation by the State of California.

11. On October 14, 1988, Defendant issued an assessment for the fiscal years in issue to Plaintiff indicating the following deficiencies in franchise tax:

Fiscal Year Ended	Amount
2/28/81	$592,685.00
2/28/82	930,777.00
Total Deficiency	$1,523,462.00

12. Plaintiff paid the above deficiences, and on May 19, 1989, Plaintiff filed a timely claim for refund for the fiscal years in issue. A copy of the Claim for Refund is attached to this Complaint as Exhibit B and is referred to and made a part of this Complaint as if set out fully in this paragraph. Plaintiff, by this reference, expressly realleges without repeating herein, each and every allegation made and fact stated in the Claim for Refund and the exhibits attached thereto.

13. On June 4, 1991, Defendant issued a Notice of Action on Plaintiff's claim for refund denying Plaintiff's refund in its entirety.

14. On August 30, 1991, Plaintiff timely filed an appeal of Defendant's Notice of Action with the California State Board of Equalization ("SBE").

15. On August 23, 1995, Plaintiff and Defendant entered into a stipulation before the SBE that for the fiscal years ended February 29, 1980, February 28, 1981 and February 28, 1982, Plaintiff overpaid franchise tax in the amounts of $3,456.00, $4,565.00 and $4,293.00, respectively. Plaintiff and Defendant further stipulated that the above amounts, plus interest allowed by law, be applied first to reduce any amounts Plaintiff owed under the Bank and Corporation Tax Law and the balance be refunded to Plaintiff. Further, because the SBE lacks jurisdiction to determine the constitutionality of California Revenue & Taxation Code provisions, Plaintiff and Defendant stipulated that the appeal filed by Plaintiff with the SBE on August 30, 1991 be dismissed by the SBE without prejudice.

16. Thereafter, on December 12, 1995, Defendant issued a Notice of Action on Cancellation, Credit, or Refund (attached as Exhibit C) granting Plaintiff certain refunds for the fiscal years in issue to the extent agreed in the August 23, 1995 stipulation and denying the remainder of Plaintiff's claim for refund.

17. Plaintiff has exhausted all necessary administrative remedies and has timely filed this suit for refund pursuant to Revenue and Taxation Code Sections 19382 et seq.

18. All of the non-unitary interest and dividends were immune from taxation by the State of California by reason of the United States Constitution. *ASARCO, Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307, 102 S. Ct. 3103 (1982); *F.W. Woolworth Co. v. Tax. & Rev. Dept.*, 458 U.S. 354, 102 S. Ct. 3128 (1982).

19. None of the disallowed interest expense was economically related to the non-unitary interest or dividends.

20. All of the non-unitary interest and dividends received by Plaintiff constituted non-unitary income.

21. The arbitrary limitation of Plaintiff's interest expense deduction by the amount of non-unitary interest and dividends constitutionally immune from taxation by the State of California results in a dollar-for-dollar indirect taxation of such constitutionally immune income.

22. Defendant erred under the California Revenue & Taxation Code in failing to grant the claim for refund in part, plus interest thereon, because the application of the "interest offset" provision under California Revenue &

Taxation Code Section 24344 violates the California Constitution and the United States Constitution, including, but not limited to: (1) the Due Process and Equal Protection Clauses of the Fourteenth Amendment of the United States Constitution, (2) the Commerce Clause (Article I, Section 8) of the United States Constitution, and (3) the Due Process and Equal Protection Clauses (Article I, Section 7) of the California Constitution.

WHEREFORE, Plaintiff prays for judgment as follows:

1. For a refund of taxes paid in the amount of $1,523,462, less the amount of tax refunded to Plaintiff pursuant to the Notice of Action on Cancellation, Credit, or Refund dated December 12, 1995;

2. For interest on these amounts as provided by law;

3. For attorney's fees and costs of suit as provided by law; and

4. For such other and further relief as this Court may deem appropriate.

Dated: March 6, 1996

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Edwin P. Antolin
Morrison & Foerster LLP

Fred O. Marcus
Horwood, Marcus & Braun

By: /s/ Charles J. Moll III
Charles J. Moll III

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Successor by Merger with
Beatrice Company, Formerly
Known as CagSub, Inc., a
Successor in Interest to
Beatrice Companies, Inc.,
Formerly Known as Beatrice
Foods Company

VERIFICATION

I am the Vice President for the Plaintiff, HUNT-WESSON, INC., Formerly Known as Beatrice/Hunt-Wesson, a Successor by Merger with Beatrice Company, Formerly Known as CagSub, Inc., a Successor in Interest to Beatrice Companies, Inc., Formerly Known as Beatrice Foods Company, and I am authorized to make this Verification on behalf of said entity.

I have read the foregoing Complaint and know the contents thereof, I am informed and believe that the information contained in said document is true, and on the ground I allege that the information stated therein is true.

I declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct.

Executed this 5th day of March, 1996, at Chicago, IL.

/s/ Raymond V. Hartman
(Signature)

[Exhibits And Proof Of Service Omitted In Printing]

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SUPERIOR COURT OF THE STATE OF CALIFORNIA

COUNTY OF SAN FRANCISCO

HUNT-WESSON, INC., Formerly Known as Beatrice/ Hunt-Wesson, a Successor by Merger with Beatrice Company, Formerly Known as CagSub, Inc., a Successor in Interest to Beatrice Companies, Inc., Formerly Known as Beatrice Foods Company, **Plaintiff,** **v.** **FRANCHISE TAX BOARD, an Agency of the State of California,** **Defendants.**	**No. 976628** **ANSWER TO VERIFIED COMPLAINT FOR REFUND OF TAXES** **(Filed Jun. 19, 1996)**

Defendant, Franchise Tax Board ("Board"), answers the verified complaint of plaintiff, Hunt-Wesson, Inc., in this action as follows:

1. Answering paragraph 1, the Board admits that plaintiff, Hunt-Wesson, Inc., is formerly known as Beatrice/Hunt-Wesson, which is a successor by merger with Beatrice Company, which is formerly known as CagSub, Inc. The Board further admits that plaintiff is a corporation organized and existing under the laws of Delaware. However, the Board is without sufficient information or belief to admit or deny that CagSub, Inc., is a successor in interest to Beatrice Companies, Inc., or that Beatrice Companies, Inc., is formerly known as Beatrice Foods, or that plaintiff's principal place of business is Fullerton, California. Based on this lack of sufficient information or belief, the Board denies these allegations.

2. Admits the allegations in paragraph 2.

3. Denies the allegations in paragraph 3.

4. Admits the allegations in paragraph 4.

5. Admits the allegations in paragraph 5.

6. Answering paragraph 6, the Board admits that plaintiff claimed interest expense in the amounts set forth in Exhibit A, attached to plaintiff's complaint, as a deduction on plaintiff's California franchise tax returns for the fiscal years in issue (fiscal years ended February 28, 1981 and February 28, 1982). However, the Board is without sufficient information or belief to admit or deny that plaintiff incurred the above-claimed interest expense during the fiscal years in issue. Based on this lack of information or belief, the Board denies this allegation.

7. Answering paragraph 7, the Board is without sufficient information or belief to admit or deny the

allegations in this paragraph. Based on this lack of information or belief, the Board denies the allegations.

8. Denies the allegations in paragraph 8.

9. Denies the allegations in paragraph 9.

10. Denies the allegations in paragraph 10.

11. Admits the allegations in paragraph 11.

12. Answering paragraph 12, the Board admits that plaintiff paid the deficiencies alleged in paragraph 11 of the complaint. The Board further admits that plaintiff filed a timely claim for refund, set forth as Exhibit B of plaintiff's complaint, for the fiscal years in issue. However, the Board denies the allegations stated in plaintiff's claim for refund and the exhibits attached thereto.

13. Admits the allegations in paragraph 13.

14. Admits the allegations in paragraph 14.

15. Admits the allegations in paragraph 15.

16. Admits the allegations in paragraph 16.

17. Denies the allegations in paragraph 17.

18. Denies the allegations in paragraph 18.

19. Denies the allegations in paragraph 19.

20. Denies the allegations in paragraph 20.

21. Denies the allegations in paragraph 21.

22. Denies the allegations in paragraph 22.

23. The Board denies generally each and every allegation of the complaint not hereinbefore specifically admitted, qualified, or denied.

AFFIRMATIVE DEFENSES

24. The Board affirmatively alleges that plaintiff has failed to state facts sufficient to constitute a cause of action.

25. The Board affirmatively alleges this Court is without jurisdiction to consider plaintiff's request for attorney's fees and costs of suit on the ground that plaintiff has failed to exhaust its administrative remedies.

WHEREFORE, the Board requests judgment as follows:

1. That the relief sought in the complaint be denied.

2. That the actions of the Board, as set forth in this Answer, be in all respects approved.

3. That this Court order all further reasonable relief.

Dated: June 19, 1996.

DANIEL E. LUNGREN, Attorney
General of the State of California

/s/ David Lew
DAVID LEW
Deputy Attorney General

Attorneys for Defendant
Franchise Tax Board

[Proof Of Service Omitted In Printing]

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SUPERIOR COURT OF THE STATE OF CALIFORNIA
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Plaintiff,

v.

FRANCHISE TAX BOARD, an Agency of the State of California,

Defendant.

IT IS HEREBY STIPULATED by and between Plaintiff Hunt-Wesson, Inc., and Defendant Franchise Tax Board ("Defendant," "the "FTB," or "the Board"), through their attorneys of record, that the following facts are agreed and undisputed. Unless specifically stated herein, these facts pertain to the fiscal years ended February 29, 1980, February 28, 1981, and February 28, 1982 ("the fiscal years in issue," "the income years in issue," or "FYE 2/29/80, FYE 2/28/81 and FYE 2/28/82"). This stipulation shall not be construed as a concession by either party of the relevance or materiality of any of the facts stipulated. The parties reserve the right to object to the admission of any document, or group of documents, or any stipulated fact, on any grounds other than those specifically waived by this stipulation.

All of the documents attached to this stipulation and marked as Joint Exhibits 1 through 6 have been reviewed by counsel for the parties, and it is admitted that they are authentic and are business records of the parties and are deemed admitted into evidence in this trial. Pursuant to California Evidence Code section 1511, photocopies of these documents will also be admitted into evidence for purposes of trial in place of the originals.

Nothing contained herein shall be construed as a waiver by any party of its right to review on appeal any question of law or fact arising in this action in the same manner and to the same extent as if the facts set forth herein had been proved in open court.

FACTS

The following facts are agreed upon and undisputed:

1. Plaintiff Hunt-Wesson, Inc., a corporation qualified to do business in California, is a successor in interest to Beatrice Companies, Inc. and Beatrice Foods Company (collectively "Beatrice"). At all relevant times Beatrice was a corporation organized and existing under the laws of Delaware, and domiciled in Illinois.

2. During the fiscal years in issue, Beatrice was a diversified company, primarily engaged in a business, both within and without California, providing food and food-related products and services for worldwide markets. Beatrice also produced other consumer, industrial and chemical products.

3. Defendant, Franchise Tax Board, is, and at all times mentioned herein was, an agency of the State of California empowered to assess and collect taxes under the California Revenue and Taxation Code, and to make refunds of overpayments of such taxes, with interest.

4. This is an action for refund of franchise taxes and interest paid by Beatrice to Defendant under the provisions of the California Revenue and Taxation Code with respect to the fiscal years ended February 28, 1981 and February 28, 1982.

5. Jurisdiction and venue for this action are vested in this Court under Sections 19382 et seq. of the Revenue and Taxation Code and Section 401 of the Code of Civil Procedure.

6. Beatrice filed timely California franchise tax returns with Defendant for the fiscal years in issue.

7. During the fiscal years in issue, Beatrice owned directly and indirectly certain dividend paying subsidiaries, none of which were incorporated in California and most of which were incorporated under the laws of a foreign country. None of these subsidiaries were engaged in a unitary business with Beatrice. These nonunitary subsidiaries paid the following dividends to Beatrice during the fiscal years in issue: $26,718,620 for FYE 2/29/80, $29,482,367 for FYE 2/28/81, and $19,022,617 for FYE 2/28/82 ("nonunitary dividends" or "nonbusiness dividends").

8. All of these nonunitary dividends received by Beatrice constituted nonunitary, nonbusiness income not subject to apportionment, or taxation, by the State of California. However, such nonunitary dividends were taxable by the State of Illinois, Beatrice's state of domicile, during the fiscal years in issue.

9. For the fiscal years at issue, Beatrice did not make direct operating loans to its foreign subsidiaries. Each foreign subsidiary was directly responsible for its own borrowings.

10. During the fiscal years in issue, Beatrice incurred interest expense in the following amounts: $80,490,469 for FYE 2/29/80, $55,101,503 for FYE

2/28/81, and $137,413,162 for FYE 2/28/82. Attached hereto as Exhibit 1 is a schedule that lists the debt and related interest expense giving rise to the interest expense deduction at issue for each year in issue. All such interest expense was reported as business interest expense and claimed as a deduction on Beatrice's California franchise tax returns for the fiscal years in issue.

11. During the fiscal years in issue, the so-called "interest offset" provision of Section 24344 of the Revenue & Taxation Code was calculated on Schedule R-5 of Defendant's Form 100 ("Corporation Franchise or Income Tax Return"). Attached hereto as Exhibit 2 is Schedule R (entitled "Schedule of Apportionment and Allocation of Income") for FYE 2/28/82. In all relevant parts, Schedule R for FYE 2/29/80 and FYE 2/28/81 was identical to Exhibit 2. Before the "interest offset" computation was made starting with line 3 of Schedule R-5, nonbusiness interest expense (line 2 of Schedule R-5) was deducted from total interest expense (line 1 of Schedule R-5). Thus, the remaining interest expense reportable on line 3 of Schedule R-5 was business interest expense subject to the "interest offset" computation.

12. After conducting an audit of the fiscal years in issue and pursuant to Section 24344, Defendant disallowed Beatrice's interest expense deduction on a dollar-for-dollar basis to the extent of the dividends that Beatrice received from its nonunitary subsidiaries. A copy of Defendant's report from that audit (including schedules) is attached hereto as Exhibit 3.

13. In computing Beatrice's "interest offset," Defendant determined that the aggregate interest expenses on

Exhibit I were reportable as interest expense on line 3 of Schedule R-5 , and thus were subject to the "interest offset" computation.

14. The disallowance of Beatrice's interest expense was due entirely to the receipt by Beatrice of dividends from its nonunitary subsidiaries as set forth in Schedule I(k) to Defendant's audit report. A copy of Schedule I(k) is attached hereto as Exhibit 4.

15. Defendant's position denying Beatrice an interest deduction pursuant to Section 24344 is based upon the analysis and holding reached by the California Supreme Court in *Pacific Telephone and Telegraph v. Franchise Tax Board*, 7 Cal. 2d 3d 544 (1972).

16. On October 14, 1988, Defendant issued a Computation of Proposed Overpayment and two Notices of Additional Tax To Be Assessed for FYE 2/29/80, FYE 2/28/81, and FYE 2/28/82, which set forth the following proposed deficiencies/(overpayment) of California franchise tax:

Fiscal Year Ended	Amount
2/29/80	($327,458.29)
2/28/81	592,685.00
2/28/82	930,777.00
Net Deficiency	$1,196,003.71

17. On December 1, 1988, Beatrice executed a Consent to Transfer in which Beatrice agreed to permit Defendant to credit against the proposed deficiency for FYE 2/28/81 the overpayment with interest thereon for FYE 2/29/80 in the aggregate amount of $804,127.91. Because

of Defendant's disallowance of Beatrice's interest expense for FYE 2/29/80, the credit against the proposed deficiency for FYE 2/28/81 was less than it would have been had the interest expense deductions been allowed. Consequently, the tax and interest paid and at issue with respect to FYE 2/28/81 is attributable both to the disallowance of Beatrice's interest expense for FYE 2/28/81, and to the disallowance of Beatrice's interest expense for FYE 2/29/80.

18. Beatrice paid the remaining proposed deficiency and interest for the fiscal years in issue in two installments: on or about March 15, 1989, Beatrice paid $2,170,458.46, and on or about July 14, 1989 Beatrice paid $387,094.40 (after Defendant allowed a credit of $28,883.09).

19. The total additional tax and interest paid by Beatrice for FYE 2/28/81 was $1,379,741.79 (consisting of $592,685 in tax and $787,056.79 in interest), and for FYE 2/28/82 was $2,010,822.07 (consisting of $930,777 in tax and $1,080,045.07 in interest).

20. The disputed tax and interest attributable to Defendant's disallowance of Beatrice's interest expense and paid by Beatrice was $139,066 (consisting of tax only) for FYE 2/29/80, $396,883.10 (consisting of $170,486 tax and $226,397.10 interest) for FYE 2/28/81, and $236,862.89 (consisting of $109,640 tax and $127,222.89 interest) for FYE 2/28/82.

21. On May 19, 1989, Beatrice filed with Defendant a timely claim for refund.

22. On June 4, 1991, Defendant denied Beatrice's refund claim in its entirety.

23. On August 30, 1991, Beatrice timely filed an appeal of Defendant's Notice of Action with the California State Board of Equalization ("SBE").

24. On August 23, 1995, Beatrice and Defendant entered into a stipulation before the SBE that for the fiscal years ended February 29, 1980, February 28, 1981 and February 28, 1982, Beatrice overpaid franchise tax in the amounts of $3,456.00, $4,565.00 and $4,293.00, respectively. Beatrice and Defendant further stipulated that the above amounts, plus interest allowed by law, be applied first to reduce any amounts Beatrice owed under the Bank and Corporation Tax Law and the balance be refunded to Beatrice. Finally, because the SBE lacks jurisdiction to determine the constitutionality of California Revenue & Taxation Code provisions, Beatrice and Defendant stipulated that the appeal filed by Beatrice with the SBE on August 30, 1991 be dismissed by the SBE without prejudice. A copy of that stipulation is attached hereto as Exhibit 5.

25. Thereafter, on December 12, 1995, Defendant issued a Notice of Action on Cancellation, Credit, or Refund, attached hereto as Exhibit 6, granting Beatrice certain refunds for the fiscal years in issue to the extent agreed in the August 23, 1995 stipulation and denying the remainder of Beatrice's claim for refund.

26. Beatrice and its successor in interest, Plaintiff Hunt-Wesson, Inc., have exhausted all necessary administrative remedies and have timely filed this suit for refund

pursuant to Revenue and Taxation Code Sections 19382 et seq.

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EDWIN P. ANTOLIN
Morrison & Foerster LLP

FRED O. MARCUS
HORWOOD, MARCUS & BRAUN
Chartered

Dated: February 6, 1997

By: /s/ Edwin P. Antolin
Edwin P. Antolin

Attorneys for Plaintiff
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DANIEL E. LUNGREN, Attorney General of the State of California

DAVID LEW, Deputy Attorney General

Dated: February 6, 1997

By: /s/ David Lew
David Lew

Attorney for Defendant
Franchise Tax Board

[Exhibits Omitted In Printing]

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SUPERIOR COURT OF THE STATE OF CALIFORNIA

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HUNT-WESSON, INC., Formerly Known as Beatrice/Hunt-Wesson, a Successor by Merger with Beatrice Company, Formerly Known as CagSub, Inc., a successor in Interest to Beatrice Companies, Inc., Formerly Known as Beatrice Foods Company, Plaintiff, v.	No. 976628 (PLAN I) **SUPPLEMENT TO JOINT STIPULATION OF FACTS** Trial Date: March 24, 1997 Continued Trial Date: April 11, 1997

FRANCHISE TAX BOARD, an Agency of the State of California,
Defendant.

Time: 9:00 am
Place: Department 17
(Filed Apr. 11, 1997)

Plaintiff Hunt-Wesson, Inc. and Defendant Franchise Tax Board hereby submit this Supplement to Joint Stipulation of Facts.

IT IS HEREBY STIPULATED by and between Plaintiff Hunt-Wesson, Inc., and Defendant Franchise Tax Board ("Defendant," the "FTB," or "the Board"), through their attorneys of record, that the following facts are agreed and undisputed. Unless specifically stated herein, these facts pertain to the fiscal years ended February 29, 1980, February 28, 1981, and February 28, 1982 ("the fiscal years in issue," "the income years in issue," or "FYE 2/29/80, FYE 2/28/81, and FYE 2/28/82"). This stipulation shall not be construed as a concession by either party of the relevance or materiality of any of the facts stipulated. The parties reserve the right to object to the admission of any document, or group of documents, or any stipulated fact, on any grounds other than those specifically waived by this stipulation.

Nothing contained herein shall be construed as a waiver by any party of its right to review on appeal any question of law or fact arising in this action in the same manner and to the same extent as if the facts set forth herein had been proved in open court.

FACTS

The following facts are agreed upon and undisputed:

1. Rev. & Tax. Code section 19340(b) states that interest shall be allowed and paid on any overpayment in respect of any tax, at the adjusted annual rate established pursuant to Section 19521 in the case of a refund from the date of overpayment to a date preceding the date of the refund warrant by not more than 30 days, the date to be determined by the FTB. Rev. & Tax. Code section 19521 provides, in relevant part, that the adjusted annual rate shall be determined in accordance with Internal Revenue Code section 6621, except as modified by section 19521. As set forth at paragraph 20 of the Joint Stipulation of Facts, the disputed tax and interest attributable to the disallowance of Beatrice's interest expense deduction and paid by Beatrice totals $772,811.99.

2. Illinois, Beatrice's state of domicile, did not have during the income years in issue (and does not have) a comparable provision to Rev. & Tax. Code section 24344(b), and did not provide (and does not provide) for an adjustment to income or expenses for the disallowance of business interest expense under Rev. & Tax. Code section 24344(b).

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Dated: April 10, 1997 By: /s/ Edwin P. Antolin
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SUPERIOR COURT OF THE STATE OF CALIFORNIA

COUNTY OF SAN FRANCISCO

HUNT-WESSON, INC., Formerly Known as Beatrice/Hunt-Wesson, a Successor by Merger with Beatrice Company, Formerly Known as CagSub, Inc., a Successor in Interest to Beatrice Companies, Inc., Formerly Known as Beatrice Foods Company,	) No. 976628 (PLAN I))) **SECOND SUPPLEMENT TO JOINT STIPULATION OF FACTS**)) Trial Date: March 24, 1997)
Plaintiff,	)
v.	) Continued Trial

FRANCHISE TAX BOARD, an Agency of the State of California,

Defendant.

Date: April 11, 1997
Time: 9:00 am
Place: Department 17
(Filed May 2, 1997)

Plaintiff Hunt-Wesson, Inc. and Defendant Franchise Tax Board hereby submit this Second Supplement to Joint Stipulation of Facts.

IT IS HEREBY STIPULATED by and between Plaintiff Hunt-Wesson, Inc., and Defendant Franchise Tax Board ("Defendant," the "FTB," or "the Board"), through their attorneys of record, that the following facts are agreed and undisputed. Unless specifically stated herein, these facts pertain to the fiscal years ended February 29, 1980, February 28, 1981, and February 28, 1982 ("the fiscal years in issue," "the income years in issue," or "FYE 2/29/80, FYE 2/28/81, and FYE 2/28/82"). This stipulation shall not be construed as a concession by either party of the relevance or materiality of any of the facts stipulated. The parties reserve the right to object to the admission of any document, or group of documents, or any stipulated fact, on any grounds other than those specifically waived by this stipulation.

Nothing contained herein shall be construed as a waiver by any party of its right to review on appeal any question of law or fact arising in this action in the same manner and to the same extent as if the facts set forth herein had been proved in open court.

FACTS

The following facts are agreed upon and undisputed:

1. Paragraph 20 of the Joint Stipulation of Facts, dated February 6, 1997, and Paragraph 1 of the Supplement to Joint Stipulation of Facts should be disregarded in their entiriety.

2. As set forth in detail in Exhibit A, attached hereto, the disputed tax and interest paid attributable to Defendant's disallowance of Beatrice's interest expense plus accrued interest from the date of payment is $762,073.12 for FYE 2/29/80 (consisting of $139,066.00 tax paid and $623,007.12 interest accrued from May 15, 1980 to May 2, 1997); $855,926.32 for FYE 2/28/81 (consisting of $170,486 tax paid, $232,752.71 interest paid, and $452,687.61 interest accrued from March 15, 1989 to May 2, 1997); and $640,021.00 for FYE 2/28/82 (consisting of $109,640.00 tax paid, $135,803.62 interest paid, and $394,577.38 interest accrued from July 15, 1989 to May 2, 1997). The total amount of tax paid, interest paid, and interest accrued from the dates of payment to May 2, 1997 equals $2,258,020.44.

3. A refund of the tax paid, interest paid and accrued interest that is paid after May 2, 1997 shall equal $2,258,020.44 plus interest from May 2, 1997 as calculated under Rev. & Tax. Code section 19391.

CHARLES J. MOLL III
EDWIN P. ANTOLIN
Morrison & Foerster LLP

FRED O. MARCUS
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Dated: May 2, 1997 By: /s/ Edwin P. Antolin
Edwin P. Antolin
Attorneys for Plaintiff

DANIEL E. LUNGREN, Attorney General of the State of California

DAVID LEW, Deputy Attorney General

Dated: May 2, 1997 By: /s/ David Lew
David Lew
Attorney for Defendant

[Exhibits Omitted In Printing]

SUPERIOR COURT OF CALIFORNIA

CITY AND COUNTY OF SAN FRANCISCO

DEPARTMENT 17

HUNT-WESSON, INC., Formerly Known as Beatrice/Hunt Wesson, a Successor by Merger with Beatrice Company, Formerly Known as CagSub, Inc., a Successor in Interest to Beatrice Companies, Inc., Formerly Known as Beatrice Foods Company, Plaintiff, v. FRANCHISE TAX BOARD, an Agency of the State of California, Defendant.	No. 976628 **PROPOSED STATEMENT OF DECISION [C.C.P. § 632]** (Filed JUN-6 1997)

Upon the oral request of both parties in accordance with Code of Civil Procedure § 632, the Court makes the following Proposed Statement of Decision:

SUMMARY

This case is brought by plaintiff Hunt-Wesson, Inc. to obtain a refund of $2,258,020.44 in taxes and interest paid to the defendant Franchise Tax Board in its fiscal years 1980, 1981 and 1982. This amount is an alleged overpayment plus (accrued interest) resulting from the application of Revenue and Taxation Code ("Rev. & T.C.")

§ 24344(b) to plaintiff's claimed business interest expense deductions for the subject three tax years. Under Rev. & T.C. § 24344(b), the defendant disallowed a portion of plaintiff's business interest expense on a dollar-for dollar basis with plaintiff's non-unitary subsidiary dividends for the subject years. Plaintiff concedes that Rev. & T.C. § 24344 was applied in accordance with its terms, but asserts that the statutory provisions that allow for business interest expense deductions to be offset by non-unitary dividends violate the Due Process, Commerce and Equal Protection Clauses of the United States Constitution.

FACTS

This matter was submitted upon a Joint Stipulation of Facts filed herein on February 6, 1997 ("JS"), a Supplement to Joint Statement of Facts filed herein on April 11, 1997, and a Second Supplement to Joint Statement of Facts filed herein on May 2, 1997 ("JS 2nd") which establish that:

A. Plaintiff[1] is a Delaware corporation, domiciled in Illinois (JS ¶ 1).

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[1] Plaintiff Hunt-Wesson, Inc. is successor in interest to other entities, the identities of which changed over the years relevant to this action. The details of this evolution, which are specified in the Joint Statement of Facts, are not relevant to this Statement of Decision as Plaintiff is the successor in interest to the actual taxpayer of the disputed payments. For simplicity, the term "Plaintiff" shall be used throughout this Statement to refer to the taxpayer and its successor in interest.

B. During its fiscal years ending February 28 of 1980, 1981 and 1982 ("the relevant fiscal years"), plaintiff was a diversified company engaged in the food products business both within and outside of California (JS ¶ 2).

C. During the relevant fiscal years, plaintiff owned dividend paying subsidiaries, none of which were either incorporated in California or engaged in a unitary business with Plaintiff (JS ¶ 7).

D. The non-unitary subsidiaries paid plaintiff the following dividends: $26,718,620 for fiscal year 1980; $29,482,367 for fiscal year 1981; and $19,022,617 for fiscal year 1982 ("the nonbusiness dividends") (JS ¶ 7).

E. All of the nonbusiness dividends were not taxable by the State of California but were taxable by the State of Illinois (JS ¶ 8).

F. During the relevant fiscal years, plaintiff incurred the following business interest expense, which it claimed as a deduction on its California Franchise Tax Returns for the respective years: $80,490,469 for fiscal year 1980; $55,101,503 for fiscal year 1981; and $137,413,162 for fiscal year 1982 (JS ¶ 10)

G. Exhibit 1 to the Joint Stipulation of Facts is a list of the debt and related expenses giving rise to the foregoing claimed business interest expense deductions. No portion of these amounts was related to borrowings of the non-unitary subsidiaries which provided the above-specified dividends to plaintiff (JS ¶ 9).

H. Pursuant to Rev. & T.C § 24344(b), defendant disallowed plaintiff's business interest expense

deductions on a dollar-for-dollar basis to the extent of the dividends that plaintiff received from its non-unitary subsidiaries (JS ¶12).

I. As a result of the disallowance of business interest expense, plaintiff paid further taxes and interest thereon, the amounts of which plus accrued interest from the respective dates of payment for the relevant fiscal years are as follows: $762,073.12 (consisting of $139,066.00 tax plus $623,007.12 interest accrued from May 15, 1980 through May 1, 1997) for fiscal year 1980; $855,926.32 (consisting of$170,486 tax plus $232,752.71 interest paid plus $452,687.61 interest accrued from March 15, 1989 through May 1, 1997) for fiscal year 1981; and $640,021.00 (consisting of $109, 640.00 tax plus $135,803.62 interest paid plus $394,577.38 interest accrued from July 15, 1989 through May 1, 1997) for fiscal year 1982 (JS 2nd, ¶20).

J. Plaintiff has satisfied all procedural requirements to bring this action for refund of the disputed payments (JS ¶¶21.23, 26).

ISSUES PRESENTED

Plaintiff's claim for refund is based on the argument that the provisions of Rev. & T. C. § 24344(b) which allow this state to offset business interest deductions claimed by foreign corporations on a dollar-for-dollar basis with such corporations' non-unitary dividends violate the Due Process, Commerce and/or Equal Protection Clauses of

the United States Constitution. As a threshold issue, however, it must be determined whether Pacific Telephone & Telegraph v. Franchise Tax Board, 7 Cal. 3d 544 (1972) precludes any Constitutional analysis of the subject provisions.

ANALYSIS

A. The Revenue & Taxation Code

California's Bank and Corporation Tax Law (Rev. & T.C. §§ 23001 et seq) is, in relevant part, a tax on corporations doing business in this state for the privilege of exercising corporate franchises in California. Rev. & T.C. § 23151. When a corporation does business both within and outside of California, the statutory scheme apportions "business income"[2] by the application of a formula which, simply put, determines the portion of such income attributable to three business factors (sales, property and payroll) which are connected with this state and taxes accordingly. Rev. & T.C. 25128. In contrast, corporate dividends are "non-business income" and are not allocated to this state unless the taxpayer is domiciled here. Rev. & T.C. § 25126. Income allocated to California under these rules is taxable by California. Rev. & T.C. § 25101.

In calculating a taxpayer's net taxable income, business interest expense is generally deducted from business income. Rev. & T.C. § 24344(a). Taxpayers must, however, offset their interest expense deductions on a dollar-for-

[2] "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business. Rev. & T.C. § 25120.

dollar basis with any non-business income not allocable to California. Rev. & T.C. §24344(b). This means that corporations not domiciled in California must reduce their interest deduction (in California) by the amount of their nontaxable (by California) dividend income. It is this effect that plaintiff asserts is unconstitutional.

B. Pacific Telephone & Telegraph v. Franchise Tax Board

Defendant asserts that Pacific Telephone & Telegraph v. Franchise Tax Board, supra, 7 Cal. 3d 544, is determinative of the issues in this case.

In Pacific Telephone, the issue presented was whether the phrase "interest and dividend income...not subject to allocation by formula" as an offset against interest deductions under Rev. & T.C. § 24344(b) should be interpreted to include all intercompany dividends.

The Court held that as a matter of statutory interpretation, logic and public policy, such intercompany dividends should be included in the subject phrase. The Court rejected Pacific Telephone's assertion that only *taxable* intercompany dividends be included in the offset because such phrase was not used in the statute and because other non-taxable dividends were expressly excluded from the computation under the statute, which express exclusion would be unnecessary if all nontaxable dividends were to be excluded. 7 Cal. 3d. at 554. The Court also found that logically, dividends are income whether or not taxed. Id. Finally, the Court found that its interpretation that nontaxable dividends should be offset against interest deductions was appropriate to close a potential loophole whereby a foreign corporation could

increase its borrowings to create a deduction and use the loan proceeds to buy stocks which would create nontaxable dividend income. 7 Cal. 3d at 554.

The Court did not expressly discuss any constitutional parameters for its statutory interpretation.[3] The absence of any constitutionally-based holding in Pacific Telephone renders that opinion not controlling on the constitutional challenges raised here. Amwest Surety Ins. Co. v. Wilson, 11 Cal 4th 1243, 1268 (1995) ["an opinion is not authority for a proposition not therein considered," *quoting* Ginns v. Savage, 61 Cal. 2d 520, 524 (1964)].

C. Constitutional Analysis.

Plaintiff asserts that the offset provisions of Rev. & T.C. § 24344 (b) violate three separate clauses of the United States Constitution: the Due Process Clause, the Commerce Clause, and the Equal Protection Clause. As a general matter, every statute is clothed with a presumption of Constitutionality. County of Sonoma v. State Energy Resources Conservation Etc. Comm., 40 Cal. 3d 361, 368-70 (1985). The power of the legislature in the area of taxation is paramount, and any constitutional restriction on that power must be strictly construed against the limitation and with reference to the underlying purpose

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[3] It should be noted that the Court stated that the problem confronting it was largely, if not entirely, eliminated by the 1967 enactment of Rev. & T.C. §25106, which expressly dealt with the applicability of intercompany dividends under Rev. & T.C. §24344. This statutory clarification may have reduced the scope of the issues presented to the Court and might therefore explain the absence of any constitutional analysis.

of the legislation. Franchise Tax Board v. Superior Court, 212 Cal.App. 3d 1343, 1347 (1989). With these principles in mind, each of the plaintiff's challenges will be discussed separately.

1. The Due Process Clause

The Due Process Clause of the Fourteenth Amendment to the United States Constitution provides that no state shall deprive its citizens of property without due process of law. In the area of state taxation, due process protections are founded on the principle that the power to tax is exercised upon the assumption that the government is providing an equivalent value to the taxpayer in the form of protections, services or facilities. Union Refrigerator Transit Company v. Kentucky 199 U.S. 194, 202 (1905). If the taxing state government is in no position to render these protections, services or facilities to the taxpayer because the object of taxation is wholly in another state, then an attempt to tax anyway is a taking without due process of law. Id. It necessarily follows that where the objects of taxation are located in two or more states, then the due process clause requires an apportionment of tax burden so as to avoid multiple taxation without regard to the protections, services and facilities being provided by the taxing states. Standard Oil Co. v. Peck, Tax Commissioner, et al, 342 U.S. 382, 384-85 (1952). Indeed, it is this precept that forms the constitutionally permissible basis for the allocation by formula approach used in unitary tax systems such as California's. Allied-Signal, Inc. v. Director, Div. of Taxation, 504 U.S. 768 (1992) ["there must be some definite link, some minimum

connection, between a state and the person, property or transaction it seeks to tax."]

In this case, the specific due process analysis starts with two basic precepts which both parties agree upon. First is that a state may not tax plaintiff's nonbusiness dividends because plaintiff is a foreign domiciliary corporation and such income is only taxable in its state of domicile. JS ¶¶ 1 & 12, see ASARCO, Inc. v. Idaho State Tax Comm'n., 458 U.S. 307, 315-16 (1982). Second is that a state cannot tax indirectly that which it may not tax directly. (Plaintiff's Proposed Statement of Decision [C.C.P. Section 632], submitted May 2, 1997, p. 6, lines 2-13; Defendant Franchise Tax Board's Proposed Statement of Decision [Cal. Rules of Court, rule 232(c)], submitted May 2, 1997, p. 13, lines 3-8).

It is in the applicability of these two precepts to this case that the parties disagree. Plaintiff asserts that the disallowance of a deduction in the amount of the nontaxable dividends effectively increases the taxable income in California by the amount of the nontaxable dividends and thus is indirectly a tax thereon. Plaintiff contends that this is impermissible given that these dividends are not taxable in California.. Defendant argues that case authorities demonstrate that the disallowance of a deduction to the extent of certain nontaxable income is proper, especially where to do so furthers a legitimate governmental purpose. Defendant's assertion will be discussed first.

Three of the five cases cited by defendant are federal cases dealing with United States tax statutes. None of these cases analyze the questioned statutes in terms of

the due process clause. In Denman v. Slayton 282 U.S. 414 (1931), the Court upheld federal tax statutes which excluded both income on tax exempt state obligations and interest on borrowings used to purchase them. In so doing, the Court rejected the taxpayer's constitutional argument that the subject statutes unconstitutionally discriminated against him. Nowhere in the opinion, however, is the precise constitutional provision supposedly prohibiting such discrimination discussed. In Helvering v. Independent Life Ins. Co., 292 U.S. 371 (1934) the Court held that a federal tax statute limiting the deduction of depreciation and other expenses did not violate Art. I, § 9, cl. 4 of the U.S. Constitution, which requires that no direct tax be laid except in proportion to the census. The Court expressly stated that it was not considering any question regarding the Fifth Amendment, which is the Federal Due Process Clause. 292 U.S. at 373. Finally, in United States v. Atlas Life Insurance Co., 381 U.S. 233 (1965) the Court upheld the portion of the Federal Life Insurance Tax Act of 1959 which required an insurance company to allocate a portion of its tax exempt interest income to its tax deductible reserve funds, thereby reducing the amount of otherwise taxable income that could be shifted to the deductible reserve funds. In so doing, it rejected the taxpayer's argument that such requirement was unconstitutional, although their exact constitutional parameters supposedly being infringed were not specified in the opinion.[4]

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[4] The Due Process Clause applicable to the Federal Government is contained in the Fifth Amendment rather than the Fourteenth Amendment. Each due process clause applies separately to its respective governmental level. Warren v. Governmental National Mortgage Association 611 F.2d. 1229, 1232 (1979;) see Shelly v. Kraemer, 334 U.S. 1, 12 (1948). The *state* fourteenth amendment due process limitations on unitary tax allocations are protections from taxation by a government which is not connected with the activity generating the earnings. Obviously this concept does not apply to a national federal government.

The remaining two cases cited by the defendant do deal with state tax provisions. The first is First Nat. Bank v. Barstow Cty. Tax Assrs. 470 U.S. 583 (1985), in which the Court upheld a Georgia tax statute which limited the exclusion of tax exempt United States obligations from the calculation of a bank's net worth on a pro rata basis with the liabilities incurred to obtain them. The second case is Missouri *ex rel* Missouri Ins. Co. v. Gehner, 381 U.S. 233 (1930), which the Court in First Nat. Bank v. Barstow Cty. Tax Assrs., supra, held "has no vitality today." 470 U.S. at 591.

The cases cited by the defendant do not provide authority for the constitutional parameters governing the state tax arrangement at issue here. These cases do, however, provide a pattern of analysis which is helpful to the resolution of this case. As was summarized in First Nat. Bank v. Barstow Cty. Tax Assrs., supra: "In sum, ever since Gehner, each time this Court has addressed the scope of the tax exemption for Government obligations, it has concluded that the exemption need not be a total exclusion, but, instead, may be limited by charging tax exempt obligations and interest their fair share of *related* expenses and burdens." Id. at 593 (emphasis added). In other words, the Court has taken a symmetrical view of taxation: income and expenses are paired so that if a

taxpayer need not include certain income in its taxable income, it cannot deduct expenses related to generating that non-included income from its taxable income.

Such logic is precisely what the California Supreme Court recognized in its concern over tax loopholes in Pacific Telephone:

> "Although dividends received by a nondomiciliary like American are not taxable in California, it is not true that such dividends are totally unrelated to California. As pointed out above in connection with the discussion of the possible loophole, a foreign corporation should not be permitted to borrow money and build up its interest expense deduction and then receive tax exempt dividends on the basis of investments made with the borrowed money. California has a substantial interest in making sure that income attributable to this state is not distorted by the use of the interest expense deduction, and under subsection (b) [of Rev. & T.C. § 24344] the dividends received are only taken into account to offset the interest expense deduction." 7 Cal. 3d at 556.

Although not so articulated by the Court in Pacific Telephone, this analysis would seem to satisfy the constitutional due process requirements that a taxing state must have "some definite link, some minimum connection" with the property it seeks to tax. Allied Signal, Inc. v. Director, Division of Taxation, supra, 768 U.S. at 777. If money were borrowed in California to pay for securities generating income not taxable in California, then California would seem to have a sufficient link to the investment

transaction to close the loophole and prevent windfall deductions for interest expense.

Rev. & T.C. § 24344(b), however, is not so targeted. It disallows interest deductions on a dollar-for dollar basis with non-taxable dividend income without regard to whether or not such interest is *related to* the dividend income. In that regard, it bears a striking similarity to the Georgia tax statute that was originally considered by the United States Supreme Court in First Nat. Bank v. Barstow Cty. Tax Assrs., supra, 470 U.S. 583. As originally presented to the Court, the Georgia statute might have been interpreted to prohibit the exclusion of all tax exempt United States obligations from the calculation of a bank's net worth. Upon that possibility, the Court remanded the case back to the Georgia Supreme Court in order to allow it to interpret its own state statute. On remand, the Georgia Supreme Court "sought to save the statute by construing it to allow a bank to deduct from its net worth 'the percentage of assets attributable to federal obligations'." Id. at 587. It was this reconsidered interpretation that was upheld by the Supreme Court. Id. at 596-97.

Synthesizing the foregoing, it would appear that Rev. & T.C. § 24344(b) runs afoul of defendant's authorities to the extent that it does not permit the deduction of interest expense not related to the generation of the taxpayer's nontaxable dividend income. Put differently, even given the possibility of a legitimate California state interest in closing the loophole recognized in Pacific Telephone, the statute is overly broad in that it goes far beyond such potential legitimate state purpose. This point is underscored in this case because here the parties have

stipulated that no portion of the proceeds of the loans generating the interest expense deductions herein went to any non-unitary corporation, each of which was responsible for its own borrowings. (J.S. ¶ 9). Thus, it appears that no portion of the interest expense deduction can be attributable to the generation of the interest exempt dividends.

Accordingly, Rev. & T.C. § 24344(b) results in a taking of plaintiff's property without due process of law and is thus in violation of the Fourteenth Amendment to the United States Constitution..

2. The Commerce Clause

Plaintiff's next argument is that Rev. & T.C. § 24344(b) violates the Commerce Clause of the United States Constitution. Plaintiff's argument is that the dollar-for-dollar offset against nontaxable income applies only to dividends of foreign corporations and is thus a Constitutionally impermissible burden on interstate commerce. Defendant asserts that on its face, the statute doe not call for a different treatment of interest expense of foreign corporations and that at most the statute discriminates against the character of income (i.e. business vs. nonbusiness) rather than upon taxpayer domicile.

The Commerce Clause to the United States Constitution provides that "the Congress shall have the power to regulate Commerce among the several states." U.S. Const., Art. I, § 8, cl. 3. The Commerce Clause has long been interpreted to have a "negative commerce clause" that precludes the states from unjustifiably discriminating against interstate commerce. Oregon Waste Systems,

Inc. v. Department of Environmental Qualifty of Oregon, 511 U.S. 93, 98-99 (1993). This negative commerce clause prohibits economic protectionism, i.e., using regulatory or taxing measures to benefit in-state economic interests by burdening out-of-state competitors. Fulton Corp. v. Faulkner, ___ U.S. ___, 116 S.Ct. 848, 853 (1996).

In the area of state taxation, it is well established that a state might further a legitimate state interest with a taxing scheme that discriminates against interstate commerce, but only where the effects thereof upon interstate commerce are just incidental. City of Philadelphia et al v. New Jersey, et al, 437 U.S. 617, 6623-24 (1978). Without a legitimate state interest being furthered, however, it is clear that a state may not tax a transaction or incident more heavily simply because there is an interstate element to it; such laws are "virtually per se invalid." Fulton Corp. v. Faulkner, supra, at 854; Armco, Inc. v. Hardesty, Tax Commissioner of West Virginia, 467 U.S. 638, 644-46.[5]

Applying these rules to this case, it is clear that Rev. & T.C. § 24344(b) violates the negative commerce clause of the United States Constitution. The starting point in this analysis is whether the provisions requiring that interest deductions be offset against nontaxable income discriminate against foreign taxpayers. The several examples provided by the parties demonstrate that the offset provisions treat two corporations in an identical business

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[5] The "virtually per se" language reflects an exception which allows a state to require that an interstate transaction bear economic tax burdens already borne by intrastate transactions. Fulton Corp. v. Faulkner, supra, at 853, and cases cited therein. This exception does not apply in this case.

transaction differently based solely on their states of domicile, which difference results in increased taxes for foreign corporations. See Tables III and IV in Pacific Telephone, supra, at pp.552-53[6]

The defendant asserts that the *tax* in question here is nondiscriminatory. Defendant argues that if anything it is the deductions that distinguish, and those differentiate not on the domicile of the taxpayer but on whether income is nontaxable (hence must be offset against otherwise allowable interest deduction). Such linguistic analysis ignores the impact of the words being dealt with. No matter how one expresses the concept, the amount of tax on a foreign corporation under Rev. & T.C. §24344(b) will be higher than that of a domestic corporation where both have a) the same taxable business income; b) the same interest expense deductions; and c) the same dividend income. The constitutionality of such a result cannot possible be determined by the statutory words used to create it, i.e. whether the discriminatory tax burden was caused by a "tax" or a "reduction of deduction due to nontaxable income". See, for example, Camps Newfound/Owatonna, Inc. v. Town of Harrison, et al, ___ U.S. ___, 97 Daily Journal D.A.R. 6299 (1997), where an exemption for charitable institutions from an otherwise generally applicable state property tax which excluded organizations which operated principally for the benefit of nonresidents was held to violate the negative commerce clause; Darnell &

[6] In addition, there is some support for the view that Rev. and T.C. §24344 was expressly designed to increase taxes on foreign corporations while reducing those of domestic corporations. See Pacific Telephone at p. 554..

Son v. Memphis, 208 U.S. 113 (1908), where Tennessee tax exemptions for in state harvested logs but not out of state harvested logs was deemed an impermissible burden on interstate commerce.

The next step in the analysis would be to determine whether California was furthering a legitimate state purpose which, if identified, might justify the differentiated treatment so long as the impact on interstate commerce was merely incidental. This step does not get off the ground. As is stated in the Due Process discussion above, Rev. & T.C. §24344(b) is overbroad and as applied to this case does not further a legitimate state purpose. As such, it is irrelevant as to whether the impact on interstate commerce is incidental or not.

Therefore, Rev. & T.C. §24344(b), which discriminates against the interstate element of foreign corporation's receipt of nontaxable dividend income outside of California violates the Commerce Clause of the United States Constitution.

3. The Equal Protection Clause

Plaintiff next agues that Rev. & T.C. § 24344(b) violates the Equal Protection Clause of the United States Constitution by impermissibly creating an arbitrary and irrational classification based on the domicile of a corporate taxpayer. Defendant asserts that the language of the statute contains no classification based on domicile and, in any event, the statutory scheme is rational in that it is designed to allow deductions of only expenses which correspond to income taxable in California.

In the area of state taxation, the Equal Protection Clause[7] precludes a state from imposing more onerous taxes or other burdens on foreign corporations than those imposed on domestic corporations, unless the discrimination between foreign and domestic corporations bears a rational relationship to a legitimate state purpose. Metropolitan Life Ins. Co. v. Ward, 470 U.S. 869, 875 (1985) [holding that the promotion of domestic industry is not a legitimate state purpose under due process analysis and rejecting Alabama's other purported interest in its higher tax rate for out of state insurers]; Williams v. Vermont, 472 U.S. 14, 23 (1985) ["A state may not treat those within its borders unequally solely on the basis of their different residences or states of incorporation."].

Applying this analysis to the present case, it is clear that Rev. & T.C. § 24344(b) violates the Equal Protection Clause. Defendant asserts that the legitimate state interest being furthered here is "to allow a deduction of only those expenses relating to an item of income which the state is not barred from taxing." Defendant Franchise Tax Board's Reply Brief, filed herein on March 13, 1997, p. 19-20. As is discussed above, however, Rev. & T.C. § 24344(b) is not so limited and precludes interest deductions to the extent of nontaxable income *irrespective of whether those deductions are related to the nontaxable income.* Since this provision applied unequally to domestic corporations and foreign corporations because only the

[7] The Equal Protection Clause provides "..nor shall any State...deny to any person within its jurisdiction the equal protection of the laws." United States Constitution, Amendment 14, Sec. 1.

dividend income of the latter are nontaxable in California, the purported state purpose is discriminatory and not rationally related to a legitimate state purpose. As such it violates the Equal Protection Clause of the United States Constitution.[8]

CONCLUSION

Rev. & T.C. § 24344(b) violates the Due Process, Commerce and Equal Protection Clauses of the United States Constitution insofar as it allows for a dollar-for-dollar offset of otherwise deductible interest expenses with nontaxable dividend income of foreign corporate taxpayers. Accordingly, the taxes and interest at issue herein were impermissibly imposed and collected. Plaintiff is therefore entitled to Judgment for $2,258,020.44 plus interest from May 2, 1997 as calculated under Rev. & T.C. § 19391.

Either party may on or before June 20, 1997 file and serve any objections or proposals hereto. Plaintiff shall prepare a proposed form of Judgment, submit it to the defendant for approval as to form, and present it to the Court on or before June 20, 1997.

Dated: June 6, 1997

Richard A. Kramer
Judge of the Superior Court

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[8] Defendant's further argument that the language of the statute does not discriminate against foreign corporations is rejected in light of the effect of the statute, as is discussed above.

SUPERIOR COURT OF THE STATE OF CALIFORNIA
FOR THE CITY AND COUNTY OF SAN FRANCISCO

DEPARTMENT: 17

HUNT-WESSON, INC.,

Plaintiff(s),

v.

FRANCHISE TAX BOARDD,

Defendant(s).

CASE NO. 976628

CERTIFICATE OF SERVICE BY MAIL (CCP 1013a(4))

I, Tatsuo Maruyama, a deputy clerk of the Superior Court for the City and County of San Francisco, certify that:

1) I am not a party to this action;

2) On June 6, 1997, I served the attached;

PROPOSED STATE OF DECISION

by placing a copy thereof in a sealed envelope, addressed as follows:

CHARLES J. MOLL, III, ESQ.
EDWIN P. ANTOLIN, ESQ.
MORRISON & FOERSTER
425 MARKET ST.
SF., CA. 94105

DAVID LEW, Deputy Atty General
STATE OF CALIFORNIA
DEPARTMENT OF JUSTICE
ATTORNEY GENERAL'S OFFICE
50 FREMONT ST. STE. 300
SF., CA. 94105

and,

3) I then placed the sealed envelope in the outgoing mail at 633 Folsom Street, San Francisco, Ca. 94107 on the date indicated above for collection, attachment of required prepaid postage, and mailing on that date following standard court practices.

Dated: JUNE 6, 1997

ALAN CARLSON, Clerk

BY: Tatsuo Maruyama, Deputy
Tatsuo Maruyama
Clerk in Department 17

NOT TO BE PUBLISHED IN OFFICIAL REPORTS

IN THE COURT OF APPEAL OF THE STATE OF CALIFORNIA

FIRST APPELLATE DISTRICT

DIVISION THREE

HUNT-WESSON, INC., Plaintiff and Respondent, v. FRANCHISE TAX BOARD, Defendant and Appellant.	)	(Filed Dec. 11, 1998) A079969 (San Francisco County Super. Ct. No. 976628)

The Franchise Tax Board (the Board) appeals from a judgment ordering the refund of over $2 million in franchise taxes and interest to respondent Hunt-Wesson, Inc. (Hunt-Wesson). The Board contends the trial court erred in holding unconstitutional Revenue and Taxation Code section 24344.[1] We agree, based on our Supreme Court's decision in *Pacific Tel. & Tel. Co.* v. *Franchise Tax Bd.* (1972) 7 Cal.3d 544 (*Pacific Telephone*), and therefore reverse the judgment.

[1] Subsequent statutory references are to the Revenue and Taxation Code.

Factual and Procedural Background

Respondent Hunt-Wesson is a Delaware corporation, domiciled in Illinois, and engaged in business in California and elsewhere.[2] During the relevant years, respondent owned, and received dividends from, certain nonunitary subsidiaries, none of which were incorporated in California and most of which were incorporated under the laws of a foreign country. The dividends constituted nonunitary, nonbusiness income and were not subject to apportionment, or taxation, by California.[3] Respondent made no direct operating loans to the subsidiaries during the relevant years.

Respondent claimed deductions for certain business interest expenses on its California franchise tax returns. Following an audit, the Board disallowed the deductions, dollar for dollar, to the extent the dividends were received from nonunitary subsidiaries, pursuant to the interest offset provision of section 24344. Respondent paid the proposed deficiencies[4] and filed a timely claim for refund. The case was submitted on stipulated facts, and the trial court ruled that section 24344 violates the Due Process, Equal Protection, and Commerce Clauses of

[2] The facts are summarized from the parties' Joint Stipulation of Facts. Hunt-Wesson is a successor in interest to Beatrice Companies, Inc. and Beatrice Foods Company, also Delaware corporations domiciled in Illinois.

[3] The dividends were taxable by Illinois, respondent's state of domicile.

[4] Respondent also agreed to permit the Board to credit an overpayment against the proposed deficiencies.

the United States Constitution. This appeal followed an order of refund below.

Issue on Appeal

Whether the interest offset provision of section 24344 is unconstitutional is a question of law over which this court exercises independent review. (*GTE Sprint Communications Corp.* v. *State Bd. of Equalization* (1991) 1 Cal.App.4th 827, 832.) "The power of the Legislature in the area of taxation is paramount, and any constitutional restriction on that power must be strictly construed against the limitation. [Citation.]" (*Franchise Tax Bd.* v. *Superior Court* (1989) 212 Cal.App.3d 1343, 1347.) Every statute is presumed constitutional (*County of Sonoma* v. *State Energy Resources Conservation etc. Com.* (1985) 40 Cal.3d 361, 368), and must be upheld unless it is " 'clearly, positively, and unmistakably' " unconstitutional. (*Calfarm Ins. Co.* v. *Deukmejian* (1989) 48 Cal.3d 805, 814.) Any doubt must be resolved in favor of the legislation; even if its validity is "fairly debatable," it must nonetheless be sustained. (*Id.* at pp. 814-815.)

When a corporation derives income from sources both within and outside the state, California's corporate franchise tax is measured by net income attributable to in-state sources. (§§ 23151, 25101.) California follows the Uniform Division of Income for Tax Purposes Act (UDITPA) (§ 25120 et seq.), which makes a distinction between business and nonbusiness income.[5] Business

[5] Business income is defined as "income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." (§ 25120, subd. (a).) Nonbusiness income is "all income other than business income." (§ 25120, subd. (d).)

income is generally calculated by applying an apportionment formula based on sales, property and payroll to the corporation's unitary business income. (§ 25128.) Nonbusiness dividend income is not apportioned, but is taxable by the corporation's state of domicile. (§§ 25123, 25126.)

In calculating taxable net income under the apportionment approach, section 24344 provides for the deduction of interest expense, subject to certain limitations.[6] Pursuant to subsection (b), interest expense is fully deductible to the extent of business interest income. Additional interest expense is then offset against nonbusiness interest and dividend income (which is not subject to allocation by formula), with the remaining interest

[6] For the relevant years, former section 24344 provided: "(a) Except as limited by subsection (b), there shall be allowed as a deduction all interest paid or accrued during the income year on indebtedness of the taxpayer. [¶] (b) If income of the taxpayer is determined by the allocation formula contained in Section 25101, the interest deductible shall be an amount equal to interest income subject to allocation by formula, plus the amount, if any, by which the balance of interest expense exceeds interest and divided income (except dividends deductible under the provisions of Section 24402) not subject to allocation by formula. Interest expense not included in the preceding sentence shall be directly offset against interest and dividend income (except dividends deductible under the provisions of Section 24402) not subject to allocation by formula."

deductible. Applying this section, the Board disallowed Hunt-Wesson's interest expense deduction on a dollar-for-dollar basis to the extent it received dividends from its nonunitary subsidiaries. Hunt-Wesson claims the application of the interest offset provision violates the Due Process and Commerce Clauses because it indirectly taxes nonbusiness dividends which could not be taxed directly, and discriminates against corporations domiciled outside California. Hunt-Wesson also argues the statute violates the Equal Protection Clause by creating an irrational classification that discriminates solely on the basis of a corporation's state of domicile.

Division One of this court recently noted that "[t]he theory of this interest offset rule is that a corporation should not be able to borrow money to purchase stocks that pay dividends and then get a deduction for the interest while the dividend income (being investment or nonbusiness income) is not taxable. [Citation]." (*Willamette Industries, Inc.* v. *Franchise Tax Bd.* (1995) 33 Cal.App.4th 1242, 1246-1247 (*Willamette*).) The *Willamette* court relied on our Supreme Court's ruling in *Pacific Telephone, supra,* 7 Cal.3d at page 554, which continues to bind us here.[7]

In *Pacific Telephone, supra,* the Supreme Court held that the Legislature had acted reasonably by treating interest expense as the opposite of dividend income, and by requiring the offset of the one against the other. (7

[7] The *Willamette* court ultimately concluded the interest offset rule did not apply in that case, because the dividends were business income, which is apportioned. (*Supra,* 33 Cal.App.4th. at pp. 1246, 1250.) That issue is not present here.

Cal.3d at pp. 551-552.) The high court rejected the taxpayer's argument that the offset should apply only to taxable dividend income. (*Id.* at pp. 553-556.) The court noted that the dividend income of a foreign corporation is not taxable in California, but concluded it comes within the language and logic of the offset statute, which is designed to offset interest expense against investment income.[8] (*Id.* at pp. 552-554.) The court noted that otherwise a tax loophole would be created, and that "a foreign corporation should not be permitted to borrow money and build up its interest expense deduction and then receive tax exempt dividends on the basis of investments made with the borrowed money." (*Id.* at p. 556.)

The Supreme Court held that inclusion of nontaxable dividends in the statutory offset computation did not constitute taxation of the dividends themselves, which were reasonably used to offset the interest expense deduction. (*Pacific Telephone, supra,* 7 Cal.3d at p. 555.) The court noted that "California has a substantial interest in making sure that income attributable to this state is not distorted by use of the interest expense deduction, and under subsection (b), the dividends received are only taken into account to offset the interest expense deduction." (*Id.* at p. 556; see also *Lyon Metal Products, Inc.* v. *State Bd. of Equalization* (1997) 58 Cal.App.4th 906, 913-914 (*Lyon*) [Legislature validly closed sales tax loophole by

[8] At the time of the *Pacific Telephone* decision, dividends of a foreign corporation were not taxable based on the doctrine of *mobilia sequuntur personam* ([movables follow the person]). (*Supra,* 7 Cal.3d. at p. 552.) Under current tax law, that doctrine has been replaced by the business/nonbusiness distinction discussed above.

adding drop shipment rule to reach transactions through out-of-state intermediaries, per Division Five of this District]; *Armour & Co.* v. *Wisconsin Department of Taxation* (1948) 32 N.W.2d 324, 326 [upholding similar restriction on interest deduction as constitutional].)[9]

Hunt-Wesson contends that the interest offset provision of section 24344 impermissibly taxes dividends which are constitutionally immune from taxation by California, and therefore violates the federal Due Process Clause. The Due Process Clause limits a state's power to impose a tax on an activity which is not connected with the taxing state. (*Allied-Signal, Inc.* v. *Director, Div. of Taxation* (1992) 504 U.S. 768, 777-778.) Thus a state may not constitutionally tax income dividends which a nondomiciliary corporation receives from subsidiary corporations having no other connection with the state. (*ASARCO, Inc.* v. *Idaho State Tax Comm'n* (1982) 458 U.S. 307, 327-329.)

Hunt-Wesson argues that the interest offset provision of section 24344 constitutes an indirect tax on immune

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[9] In explaining its reasons for declining to limit the coverage of subdivision (b) to taxable dividends in *Pacific Telephone, supra,* the Supreme Court listed as an additional factor the language of the section itself, which is phrased as a limitation on the deduction of interest expense. The court noted this view was reinforced by a letter sent from the Board to Governor Knight, before he signed the legislation, stating the provision would increase taxes on foreign corporations while reducing those of domestic corporations. (7 Cal.3d at p. 554.) Despite that potential indirect effect on foreign corporations, the Supreme Court upheld the interest offset provision, determining that it did not constitute a tax. (*Id.* at p. 555.)

income, increasing a nondomiciliary corporation's tax liability solely because it receives nontaxable dividends. Hunt-Wesson also argues that the interest offset is overbroad, because it fails to apportion interest expense, but creates a dollar-for dollar offset. If we were writing on a clean slate, these arguments might appear persuasive. In *Pacific Telephone, supra,* however, the California Supreme Court explicitly held that inclusion of nontaxable dividends in the statutory offset computation under section 24344 does not constitute taxation of the dividends themselves. (7 Cal.3d 544.) We defer, as we must, to that decision. (*Auto Equity Sales, Inc.* v. *Superior Court* (1962) 57 Cal.2d 450, 455.)

Although, as Hunt-Wesson points out, the *Pacific Telephone* case did not involve a constitutional challenge to section 24344, our Supreme Court clearly recognized the dividend income itself was not taxable in California, while upholding the interest offset provision of section 24344. (*Supra,* 7 Cal.3d at pp. 549, 552.) Hunt-Wesson's argument that *Pacific Telephone* is "an outdated, obsolete case" must be addressed to courts of superior jurisdiction to our own.[10]

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[10] Hunt-Wesson also argues the language in *Pacific Telephone* is dictum, because the taxpayer, being domiciled in California, did not contest the inclusion of the nonbusiness dividends in the interest offset provision. The taxpayer in *Pacific Telephone,* however, was a member of a unitary business (most of whose members were domiciled outside California) whose California tax liability was greater than it would have been without the application of section 24344 (*supra,* 7 Cal.3d at p. 546), because interest expense, which would otherwise have been an apportionable business expense of the entire unitary business, was assigned to non-California domiciliaries. After the tax year

Hunt-Wesson also contends the interest offset statute is unconstitutional because it discriminates against interstate commerce in violation of the Commerce Clause. First, Hunt-Wesson argues section 24344 denies the interest deduction only to non-California corporations, imposing a facially discriminatory tax which is "virtually per se invalid." This argument again collides with our Supreme Court's holding in *Pacific Telephone* that the interest offset provision does not constitute a tax on the dividends in question. Moreover, the cases on which Hunt-Wesson relies are distinguishable. In *Fulton Corp.* v. *Faulkner* (1996) 516 U.S. 325, for example, the intangibles tax involved was discriminatory on its face, taxing stockholders only to the degree that the issuing corporation participated in interstate commerce, and the only real issue was whether the deduction in question could be sustained as compensatory. (*Id.* at pp. 333-334.) Here, by contrast, the alleged favorable effect on local commerce is indirect and incidental. Section 24344, which is part of an overall apportioned tax scheme, does not distinguish between domestic and foreign corporations, and the same rules and logic of offsetting interest expense against investment income are applied to both. (See *Pacific Telephone, supra,* 7 Cal.3d at p. 558.) Deductibility of interest

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there in issue, the Legislature eliminated unitary intercompany dividends from the tax base and the subsection (b) computation. (*Id.* at p. 558, fn. 11.) The Legislature did not, however, similarly adjust the treatment of non-unitary dividends, which are at issue here. We are unable to distinguish *Pacific Telephone* on any principled basis. Because we conclude the fact asserted by Hunt-Wesson does not serve to distinguish the case, *Pacific Telephone's* holding dictates the outcome here.

expense is determined not by the corporation's domicile, but by the character of the income attributable to that expense.[11]

Thus the facial discrimination cases (with their concomitant rule of virtual per se invalidity) upon which respondent relies are not determinative. (See, e.g., *Camps Newfound/Owatonna, Inc.* v. *Town of Harrison* (1997) 520 U.S. 564, 572-583 [reduction of state property tax exemption for charities operated principally for benefit of nonresidents was facially discriminatory and thus invalid]; *Oregon Waste Systems, Inc.* v. *Department of Environmental Quality of Ore.* (1994) 511 U.S. 93, 99-100 [surcharge on disposal of waste generated out of state was discriminatory on its face, triggering rule of virtual per se invalidity]; *Philadelphia* v. *New Jersey* (1978) 437 U.S. 617, 623-629 [New Jersey law banning waste imported from other states violated Commerce Clause].) In the absence of a directly applicable ruling by the federal Supreme Court holding unconstitutional an interest offset provision such as the one in issue here, we remain bound by *Pacific Telephone, supra.* In fact, respondent has not cited, and our research has not uncovered, any decision, federal or state, holding such a provision unconstitutional.

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[11] The Board points out that domicile is not necessarily the operative component in determining where nonbusiness income is taxable. (See § 25125, subd. (d) [allocation of gain or loss on sale of partnership interest allocable by ratio based on original cost of partnership tangible property both in and out of state]; § 25127 [patent and copyright royalties allocable to extent utilized in state].)

Hunt-Wesson also argues section 24344 unlawfully discriminates by excluding from the interest offset computation under section 24402 dividends declared from income previously taxed by California. Hunt-Wesson contends this exclusion favors investment in California subsidiaries over investment in subsidiaries not doing business in California. Because California has previously taxed the income in question, however, we discern no unconstitutional discrimination in the state refraining from double taxation. (See *Pacific Telephone, supra,* 7 Cal.3d at p. 548, fn. 4.) Unlike *Fulton, supra,* on which respondent relies, the statute does not waive an otherwise uniform intangibles tax, based simply on the percentage of the underlying corporate income taxed by the state. Instead, it operates as part of an overall apportioned tax scheme, matching expenses with income in a manner which our Supreme Court has determined to be reasonable. (*Pacific Telephone, supra,* 7 Cal.3d at pp. 551-552, 555.)

The parties also disagree as to the application of the "internal consistency" test here. (See *Oklahoma Tax Comm'n* v. *Jefferson Lines, Inc.* (1995) 514 U.S. 175, 185.) "Internal consistency is preserved when the imposition of a tax identical to the one in question by every other State would add no burden to interstate commerce that intrastate commerce would not also bear." (*Ibid.*) The Board contends that section 24344 does not affect respondent's overall tax liability, because if all the states in which it is taxable adopted similar provisions, respondent's taxable income in Illinois would decrease in proportion to the amount its taxable income in California would increase.

Respondent disagrees, also asserting that internal consistency is not sufficient. We need not decide this theoretical point, because the "internal consistency" standard is applicable only to taxes, and our high court has held the interest offset provision is not a tax on the income in question here. (*Pacific Telephone, supra,* 7 Cal.3d at p. 555.) Moreover, the United States Supreme Court has held that the Commerce Clause does not require absolute precision in interstate taxation, noting that the States have adopted differing rules regarding business and nonbusiness income and their attribution for apportionment purposes. (*Moorman Mfg. Co.* v. *Bair* (1978) 437 U.S. 267, 278-281 [rejecting argument that Commerce Clause prohibits any overlap in computation of taxable income by the States].)

Nor does the interest offset provision deprive appellants of their equal protection rights. Hunt-Wesson concedes that the only inquiry under the Equal Protection Clause is whether there is a rational relationship between the State's classification and its objective. The provision here is rationally related to California's need to close an otherwise gaping tax loophole, as explained in *Pacific Telephone, supra.* Unlike the discriminatory taxes struck down in the cases cited by Hunt-Wesson, section 24344 does not create an arbitrary classification based solely on state of domicile. (Compare *Williams* v. *Vermont* (1985) 472 U.S. 14, 23 [discriminatory exemption from use tax based solely on state of residence did not serve legitimate state purpose]; *Metropolitan Life Ins. Co.* v. *Ward* (1985) 470 U.S. 869, 878 [state may not promote domestic business by

taxing foreign corporations at a higher rate solely because of their residence].)[12]

Disposition

The judgment below is reversed. The matter is remanded to the trial court with directions to enter judgment for the Board.

Corrigan, J.

We concur:

Phelan, P.J.

Walker, J.

A079969, *Hunt-Wesson, Inc.* v. *Franchise Tax Board*

[12] Respondent asserts that the legislative history of section 24344 indicates it was enacted to benefit California corporations, apparently referring to the letter from the Board to Governor Knight mentioned in *Pacific Telephone, supra,* 7 Cal.3d at p. 554. While the letter reportedly stated the provision would increase taxes on foreign corporations while reducing those on domestic corporations, the Board points out here that the letter indicates no intent to discriminate against foreign corporations but merely notes the likely consequence of section 24344 which results from plugging the tax loophole. This is a permissible subject of legislation. (See *Lyon, supra,* 58 Cal.App.4th at pp. 913-914.)

First Appellate District, Division Three, No. A079969
S076104

IN THE SUPREME COURT OF CALIFORNIA

HUNT-WESSON INCORPORATED, Respondent

v. (Filed MAR. 24, 1999)

FRANCHISE TAX BOARD, Appellant

Respondent's petition for review DENIED.
The request for an order directing publication of the opinion is denied.

Kennard, J., is of the opinion the petition for review should be granted.

GEORGE
Chief Justice